Insurance

Takaful: Growth opportunities in a dynamic market*

*connectedthinking

PricewaterhouseCoopers

Contents

Introduction

Takaful, the name for Islamic-compliant insurance, can be translated as 'shared responsibility'

The world's youngest and most dynamic insurance market in reality traces its origins back more than 1,400 years. Takaful, the name for Islamic-compliant insurance, can be translated as 'shared responsibility' and refers to the co-operative risk-sharing beginnings of takaful – not unlike the birth of insurance within different communities in Europe and the US.

Takaful originated within the ancient Arab tribes as a pooled liability that obliged those who committed offences against members of a different tribe to pay compensation to the victims or their heirs. This principle extended to many walks of life, including sea trade, in which participants contributed to a fund to cover anyone in a group who suffered mishaps on sea voyages.

However, it was not until 1979, in Sudan, that the first modern takaful company was set up.[1] In 1985, the Grand Council of Islamic Scholars of the Organisation of the Islamic Conference formally allowed the use of takaful as the Islamic alternative to conventional insurance. Conventional insurance was deemed to be incompatible with Islamic law ('Shariah') and was to be avoided by Muslims, unless there was no alternative. The objections to conventional insurance were based on the Islamic principles of not allowing *uncertainty* or any *interest*-bearing assets, both of which are inherent factors in conventional insurance business.

This paper is the first in a series of PricewaterhouseCoopers'[2] publications aimed at briefing mainstream financial services companies about opportunities in Islamic finance.

1 Salaam Insurance Company (www.salaam.co.uk), 12.06.08.
2 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal identity.

Overview

Takaful contributions are forecast to grow roughly six-fold over the next decade

- Takaful is based on solidarity and risk-sharing principles. It is an Islamic form of financial protection, similar to conventional insurance, and it has been established in its modern form for more than 25 years. The market now comprises some 130 companies in both Muslim and non-Muslim (including Western) countries.[3]
- Takaful arrangements can be used to pool either general insurance risks or life (known as family takaful) risks, covering the same spectrum as conventional insurance.
- Takaful companies have to follow Islamic finance principles, such as producing Shariah-compliant contracts for clients and appointing a board of Shariah scholars to ensure that both the products and the operations of the company comply with Shariah.
- Takaful insurers are required to invest in Shariah-compliant products where possible. With the dearth of short–term Shariah-compliant assets, however, many takaful insurers are having to invest in conventional assets in order to meet the regulatory constraints of the countries they are domiciled in.
- The transparency of contracts used in takaful and the avoidance of industries such as alcohol, gambling and tobacco in the investment portfolios of takaful companies potentially appeals to a wider category of non-Muslim customers seeking ethical financial services.
- Conventional insurance penetration is comparatively low in affluent Muslim societies like Qatar, Kuwait and the UAE. Takaful is seen as a key to increasing insurance awareness and delivering on customer expectations by capitalising on the positive economic dynamic of regions like the Gulf. In the more mature Islamic finance economies, takaful is price competitive with equivalent conventional insurance products and has significant proportions of non-Muslims as customers.
- The world's 1.5 billion Muslims[4] represent a huge potential customer base, and form a youthful and increasingly affluent society. Takaful contributions are forecast to grow roughly six-fold over the next decade.[5] The ethical element is also a powerful business argument for attracting non-Muslim customers to takaful.
- There is an opportunity for retakaful operators to assist the growth and expansion of takaful insurance. There is a shortage of retakaful capacity and this has left takaful insurers with the dilemma of having to reinsure on a conventional basis, contrary to the customer's preference of seeking cover on Islamic principles.

3 Arab Insurance Group, *Islamic Insurance Directory*, 06.
4 *CIA World Factbook*, (www.cia.gov), 12.06.08.
5 'Takaful Takes Off', *The Banker*, 04.07.

Key features of takaful

The takaful system helps to eliminate issues of risk and uncertainty and this constitutes a key part of making takaful structures acceptable under Islamic law

- The customers (policyholders) of the takaful business agree to pool their contributions and share the liability of each policyholder. So if one policyholder has to be paid a claim, this is paid out of the combined pool of the policyholders' contributions.

- As with mutual insurance, the policyholders share in the profit and loss of the takaful business, i.e. the policyholders all share the insurance risk – they do not give the risk to the takaful company (as occurs in a conventional shareholder insurance company). Consequently, if at the end of a financial year, the takaful business makes a surplus, this is shared between the takaful policyholders.

- If at the end of the financial year the policyholders' fund makes a loss, this deficit is funded by an interest-free loan from the shareholders' fund. The shareholders' fund is then repaid the loan from any future surpluses of the policyholders' fund. The shareholders cannot access the capital from the policyholders' fund except when the interest-free loan is being repaid.

- The assets of the takaful business have to be invested in Shariah-compliant assets. For example, investments can't be made in gambling institutions, businesses that make alcohol, businesses that sell weapons or assets that pay interest.

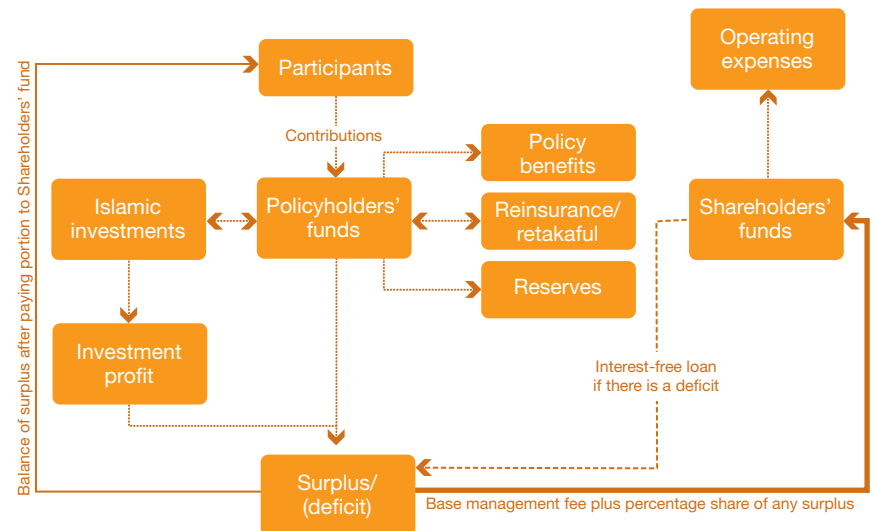
- The operators of the business are paid explicit fees for setting up and running the company on behalf of the policyholders. These fees should cover all the setting-up costs, running costs and profit loading of the shareholders and are the only way that the shareholders are remunerated. After the fees are deducted, any surplus arising from the takaful business is shared amongst the policyholders only. These explicit fees are in the takaful contract that each policyholder signs with the takaful company and are fully transparent.

There is no unique operating model for takaful companies, as each country has its preferred model

There is no unique operating model for takaful companies, as each country has its preferred model. However the most widely used models are mudharaba, wakala and the hybrid model.

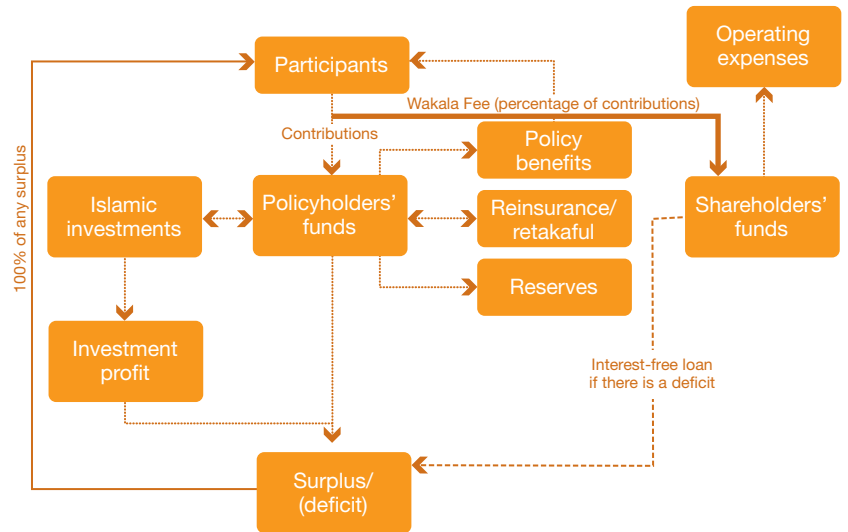
Mudharaba (Figure 1) is known as the profit-sharing model. The shareholders share in the profit or loss with the policyholder. In this model, the shareholders are paid:

- A pre-agreed proportion of any surplus generated by the policyholders' fund in return for running the insurance operations of the takaful business on behalf of the policyholders. If the policyholders' fund makes a loss, the operator provides an interest-free loan as explained above; and
- A pre-agreed proportion of any investment income from investing the policyholders' fund's assets on behalf of the policyholders.

Figure 1: Mudharaba model

Source: PricewaterhouseCoopers

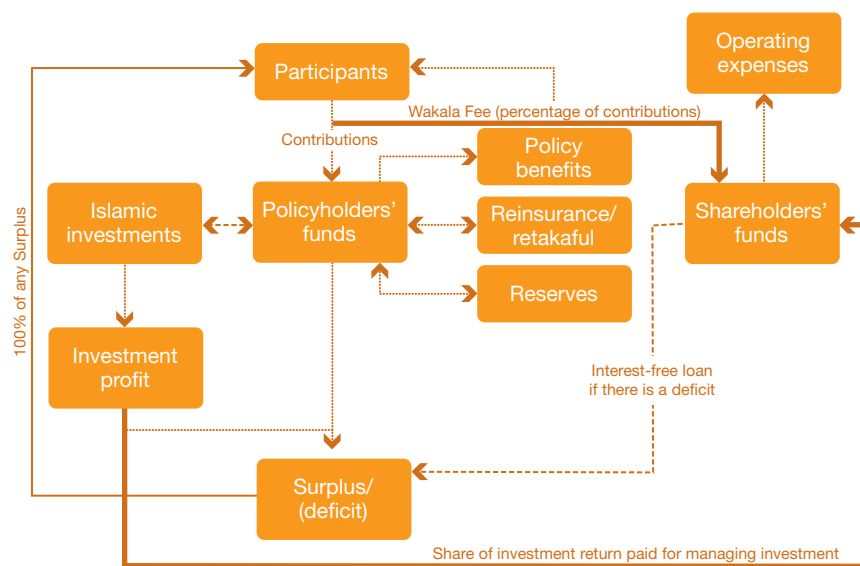
Key features of takaful (continued)

In the wakala (Figure 2) model, the operator acts as an agent of the participants. In this model, shareholders are paid a pre-agreed proportion of the contributions paid by the policyholders in return for running the insurance operations of the takaful business on behalf of the policyholders. If the policyholders' fund makes a loss, the operator provides an interest-free loan to the policyholders' fund that is repaid out of future surpluses in the fund.

Figure 2: Wakala model

Source: PricewaterhouseCoopers

The hybrid (Figure 3) model is a mix of the mudharaba and wakala models. In this model, the operator receives a wakala fee for managing the insurance operation of the policyholders' fund as well as a mudharaba fee for managing the investment fund. This model is widely used in the Gulf Co-operation Council (GCC) countries, with the exception of Saudi Arabia.

There are also some country-specific models, such as the wakala waqf model widely used in Pakistan and South Africa. In this model the policyholders' fund is replaced by a trust, which is the waqf fund. Part of the capital of the shareholders' fund is used to create this trust, which is considered charitable under local law.

Figure 3: Hybrid model

Participants
Operating expenses
Wakala Fee (percentage of contributions)
Contributions
Policy benefits
Islamic investments
Policyholders' funds
Reinsurance/ retakaful
Shareholders' funds
Reserves
100% of any Surplus
Investment profit
Interest-free loan if there is a deficit
Surplus/ (deficit)
Share of investment return paid for managing investment

Source: PricewaterhouseCoopers

Market potential

There are currently more than 130 takaful companies in operation worldwide

The takaful market is currently concentrated in Malaysia and the Middle East and has been experiencing significant growth rates. There are currently more than 130 takaful companies in operation worldwide, of which nearly half are to be found in the GCC countries of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE. The takaful growth rate in these countries is well ahead of the conventional insurance market in the region. With regard to takaful, the market is expected to be worth $4 billion in the next few years at the present rate of expansion, compared with about $170 million today.[6]

In some countries with majority Muslim populations, such as Nigeria, Pakistan, Egypt and Bangladesh, the takaful market can be considered very much in the embryonic stage. These are almost totally untapped markets, in which insurance penetration hovers somewhere below 2% of GDP.[7] Globally, some estimate that the global takaful industry is growing at 20% per year, far outstripping the 2.5% annual growth for conventional insurance premiums.[8] Moody's has predicted that global takaful premiums will rise to $7bn by 2015.[9]

The international rating agencies have also taken a keen interest in the development of the takaful industry. For example, the credit-rating agency Standard & Poor's applies the same analytical process for takaful businesses as for conventional insurers, but will also take into account factors like the takaful sector's positive growth dynamics.[10] In terms of the governance structure, takaful companies have the same structure as conventional insurers but also have an independent Shariah board. The role of this board is to ensure that the processes, investments and products of the takaful company are Shariah compliant.

The world's 1.5 billion Muslims[11] represent a potential customer base that no insurer can afford to ignore. Unlike most Western countries, the bulk of the world's Muslim population is youthful. In fact, 60% of the global Muslim population is under 25 years of age.[11] This youthful population is starting to achieve a certain level of affluence and if it can be captured early, has the potential to be a customer base to be retained for 40 years or more. The under-insured status of most Muslims is also a significant enticement to potential takaful operators. Taken as a percentage of GDP, premiums in the developed world, including Japan and the Asian 'Tiger Economies', average

6 Standard & Poor's, 'Islamic Finance Outlook', 23.04.07.
7 Morgan Stanley, 'Takaful Insurance: an Introduction', 29.04.08.
8 Islamic Finance News, 'Takaful Guide 2007'.
9 Moody's, 'Middle East Insurance Set for Continued Expansion', 02.08.
10 Standard & Poor's, 'Islamic Finance Outlook', 23.04.07.
11 *CIA World Factbook* (www.cia.gov), 12.06.08.

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9.3%. In the Middle East, Africa, South and East Asia, premiums amount to only 3% of GDP. Growth forecasts for takaful vary, but the consensus amongst most market forecasters is for the current level of worldwide contributions written by takaful insurers, estimated at roughly $2.0 to $2.6 billion as of 2006, to soar to $7.0 billion or more by 2015.[12] This is well on its way to becoming a reality, for the forecast of $2.1 billion[12] in contributions by 2010, which was published by *Asian Insurance Review* a decade ago,[13] has already been surpassed. However, when compared with the $3.7 trillion level of global premiums for conventional insurance, the enormous growth potential for takaful becomes obvious.

Insurers and customers are starting to realise that:

- there is a significant market for takaful;
- takaful products can be price competitive with conventional insurance products; and
- takaful is inherently ethical and is obliged to invest in ethical products. Further if the takaful business makes money, it gives a share of this surplus back to the policyholders.

This combination of ethical investment policy, significant growth potential and price competitiveness makes for a compelling business proposition to non-Muslims as well, in the UK, the rest of Europe and the US. This is a strong driver in markets where the majority of the population is not Muslim. There are two million Muslims in the UK and 20 million in Europe, while in the US the estimates range from 2 million to 6 million.[14] But if non-Muslims seeking an ethical investment come in as takaful customers, the market then becomes one of almost 60 million in Britain and some 450 million in Europe.

12 Morgan Stanley, 'Takaful Insurance: an Introduction', 29.04.08.
13 *Asian Insurance Review*, 'Takaful growth forecasts', 1998.
14 'Muslims in Europe: Country guide' (www.bbc.co.uk), 23.12.05.

Retakaful

Takaful companies have actively promoted co-insurance but still have a significant need to reinsure

There is also a global need for strong and credible retakaful operators to assist the growth and expansion of takaful insurance. There is currently a shortage of retakaful capacity and the lack of companies in the market presents a challenge as well as an opportunity.

Shariah scholars have allowed takaful operators to reinsure conventionally when no retakaful alternative is available, although retakaful is strongly preferred. Takaful companies have actively promoted co-insurance but still have a significant need to reinsure. As there is a lack of capacity within the retakaful industry worldwide, a certain proportion of risk is placed with reinsurance companies that operate on a conventional basis, both conventional reinsurers based in Muslim countries and international reinsurers. However, this conventional reinsurance represents a dilemma, as it is contrary to the customer's preference of seeking cover on Islamic principles.

Structurally retakaful is operated in a similar manner to the takaful operating models described in the key features section of this paper, and the same Shariah principles apply.

General, health and family (life) takaful opportunities

Life takaful penetration, at present, lags far behind general and health takaful, as Muslims tend to have greater inhibitions when it comes to life insurance

Takaful insurance comprises general (property and casualty) insurance, as well as life, medical and health, accident and education plans. General takaful accounts for the majority of business in the Middle and Far East markets, with property and accident insurance making up approximately half the written business.

Health takaful is a rapidly growing sector in the GCC as health insurance is increasingly being made compulsory in GCC countries. Life takaful penetration, at present, lags far behind general and health takaful, as Muslims tend to have greater inhibitions when it comes to life insurance. At present, gross takaful contributions from life insurance in these two regions amounts to less than 7% of total written business.[15] However, with the development of innovative family takaful products and the increasing education of Muslims as to why family takaful is Shariah compliant, it is reasonable to assume that life takaful will grow substantially.

15 Morgan Stanley, 'Takaful Insurance: an Introduction', 29.04.08.

Challenges for takaful operators

People have to be made aware that takaful provides an acceptable religiously validated solution. Similarly, non-Muslims need to be made aware of why takaful is ethical.

The potential for takaful is beyond question. But there are many hurdles to overcome if this market is to realise its potential. Human resources pose a major obstacle to growth, as the market is facing a severe shortage of qualified staff who understand both technical insurance principles and have an adequate awareness of Shariah finance.

One of the biggest challenges is creating customer awareness. Many Muslims live under the misconception that insurance is contrary to the principles of Islam, particularly with regard to life insurance. People have to be made aware that takaful provides an acceptable religiously validated solution. Similarly, non-Muslims need to be made aware of why takaful is ethical.

Countries where takaful is new also need to set out clear principles on how takaful business should be taxed, and to create a regulatory regime that does not treat takaful less favourably than conventional insurance. In the UK, Europe and the US, there is also limited experience of how takaful can be accounted for and how to run takaful businesses not only to be Shariah compliant but also to comply with local national regulatory insurance rules.

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has created a standard that is the default accounting standard for takaful businesses in some Middle East countries. Takaful businesses in other countries account for takaful under International Financial Reporting Standards (IFRS). Applying IFRS to takaful is a complex area and will be the subject of a separate PricewaterhouseCoopers' paper.

The limited availability of short-term non-equity financial instruments such as sukuk and Shariah-compliant money market instruments equivalent to treasury bills represent a further challenge for takaful companies, making managing their investment portfolio more challenging than for conventional insurers who can simply invest in bonds and cash assets.

Takaful companies that grow rapidly (as has been seen in Malaysia and is currently being seen in the Middle East) face the challenge of ensuring that the systems that they have in place can cope with such rapid growth. Along with these challenges, takaful providers must enhance their product innovation and continue to offer a high level of customer service. They must be able to understand evolving customer and market-specific needs and be willing to renew or re-engineer product design and consumer benefit packages, as well as expand customer reach across various distribution channels.

How PricewaterhouseCoopers can help

Globally we have more than 700 actuaries and takaful specialists serving general, family, health takaful and retakaful markets.

The market opportunity represented by takaful is too significant to ignore. The challenge is to enter the market quickly while minimising costs and risks.

PricewaterhouseCoopers has a strong team of specialists in takaful with wide-ranging experience in helping companies in all areas of the business. We bring to the table the global resources of one of the world's largest networks of takaful experts, with centres of excellence in Malaysia, the Middle East and North Africa (MENA) and London. Globally we have more than 700 actuaries and takaful specialists serving general, family, health takaful and retakaful markets.

We have solutions for the major challenges facing takaful operators, such as tax issues, the potential lack of IT and operating infrastructure. We offer cutting-edge solutions to issues, from optimising capital requirements, design and development of management information systems, to managing the impact of an insurer's conventional and takaful portfolio. We have carried out work for all elements of takaful business, from reviewing business plans and helping people deal with investors, to financial modelling of takaful businesses on an IFRS basis and on an AAOIFI basis. We have helped takaful businesses at all stages of their development; from helping companies get established to reviewing and optimising their reserving, underwriting and finance processes and controls and helping CEOs plan their strategies for growth.

PricewaterhouseCoopers is committed to bringing the best knowledge to financial services organisations across its global network. We resource projects with staff from local offices and the wider PricewaterhouseCoopers' network firms to best match the needs of our clients. This ensures that organisations obtain local expertise and the benefit of our market-leading insurance expertise from around the globe.

Glossary

Mudharaba: A form of partnership under Islamic law where one partner contributes capital and the other partner contributes personal effort.

Shariah: Islamic law.

Shariah board: A panel of Shariah Scholars who approve proposed new products and also review the operations of the company to provide an opinion that its activities have been conducted in a Shariah compliant manner.

Sukuk: the Islamic equivalent of a bond.

Wakala: An agency agreement.

Waqf: A trust fund.

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If you would like to discuss any aspect of the issues raised in this paper, please speak to your usual contact at PricewaterhouseCoopers or any of those listed below.

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